Simpson Thacher

# Memorandum

## SEC Declines Second Circuit's Invitation to Submit Amicus Brief on Whether Certain Syndicated Term Loans Are Securities

July 19, 2023

On July 18, 2023, the Securities and Exchange Commission (SEC) declined to file an amicus brief in *Kirschner v. JP Morgan Chase Bank, N.A.*,[1] a case pending before the Second Circuit Court of Appeals alleging violations of securities laws in connection with the syndication of term loans. In a letter to the Second Circuit, the SEC staff indicated that it was "not in a position to file a brief" on the matter before the court, without offering further explanation. The case has been closely watched in the leveraged finance community for signs that the court could alter the traditional distinction between term loans and securities. The SEC's decision not to provide a view in this matter comes after it had requested (and received) three extensions from the Second Circuit of its original deadline to respond, citing its efforts to consult with other federal agencies.

The *Kirschner* case is on appeal to the Second Circuit after the Southern District of New York granted the defendant banks' motion to dismiss. The District Court, applying the four-factor test established by the Supreme Court in *Reves v. Ernst & Young*,[2] which we describe below, found that the syndicated term loans at issue did not constitute securities and thus were not subject to state securities laws. The plaintiff argues that the *Reves* test was erroneously applied, and the Second Circuit invited the SEC to express its views on the question of whether the syndicated term loans at issue constitute securities.

In this client alert, we outline a few potential outcomes in the case before briefly describing the background of the case for reference.

### Potential Outcomes in the Second Circuit Case

The SEC's decision not to offer its views on the issues in the *Kirschner* case may make it easier for the Second Circuit to affirm the District Court's decision based on existing precedent. A ruling by the Second Circuit in favor of the defendant banks would preserve the existing legal framework for the syndicated lending market, allowing the market to continue to operate as it currently does.

Procedurally, since Kirschner appealed the District Court's grant of the defendants' motion to dismiss, the Second Circuit could also decide to remand the case to the District Court with instructions to determine whether the

[1] *Kirschner v. JP Morgan Chase Bank, N.A.*, 2020 U.S. Dist. LEXIS 90797 (S.D.N.Y. May 22, 2020).

[2] *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

particular loans are securities at the fact-finding stage rather than on the pleadings, leaving the question of whether the *Kirschner* term loans are securities unresolved and without conclusive precedential import.

However, should the Second Circuit adopt the plaintiff's view that certain term loans should be treated as securities, borrowers, arrangers and lenders would have to evaluate changes to current market practices in light of the potential application of securities regulations to the syndicated lending market, including secondary trading. Changes to current processes could include updates to documentation, as well as an increased focus on diligence and disclosure. These modifications would likely increase costs for borrowers, and new market practices could take time to evolve. The SEC's election not to submit a brief in the case may make this outcome less likely, but the market will need to await the court's decision.

## Overview of *Kirschner v. JPMorgan Chase Bank, N.A.*

### FACTUAL BACKGROUND

In April 2014, four arranging banks—JPMorgan Chase Bank, Citibank, Bank of Montreal and SunTrust Bank—extended to Millennium Laboratories LLC, a urine drug testing company (Millennium), credit facilities consisting of a $50 million revolving loan and a $1.775 billion term loan. Approximately 70 institutional investor groups, comprised of roughly 400 mutual funds, hedge funds and other institutional investors, chose to participate in the syndication of the term loan. All entities participating in the syndication made representations in the governing loan documents disclaiming reliance on information about Millennium provided by the arranging banks and individually assumed responsibility for conducting due diligence into Millennium's creditworthiness.

At the time the loan was made in April 2014, Millennium was engaged in civil litigation with a competitor about its Medicare and Medicaid billing practices and was the subject of criminal and civil Department of Justice (DOJ) investigations based on the acts alleged in the litigation. After an adverse jury verdict in the civil case and a large settlement with the DOJ, Millennium defaulted on its term loan and filed for bankruptcy in November 2015.

Following Millennium's collapse, Marc Kirschner, the trustee of The Millennium Lender Claim Trust, brought suit against the four arranging banks alleging, in part, that the banks made misrepresentations and omissions about Millennium's risks when they syndicated the loan to the lenders, thereby violating state securities (blue sky) laws on the theory that the notes evidencing the loans were in fact securities.

### RULING OF THE DISTRICT COURT, APPEAL AND SECOND CIRCUIT'S INVITATION TO THE SEC

In May 2020, the Southern District of New York granted the defendant banks' motion to dismiss Kirschner's complaint. The District Court relied upon the four-factor test established in *Reves* and its application of the test in *Banco Espanol de Credito v. Security Pacific National Bank*.[3] The *Reves* test begins with the presumption that

[3] *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992).

every note is a security and then outlines four factors to determine if the presumption can be overridden: (1) the motivations underlying the sellers and buyers' entrance into the transaction, (2) the plan of distribution for the instrument, (3) the reasonable expectations of the investing public and (4) whether an alternate regulatory scheme exists that may protect buyers.

The District Court held that Kirschner failed to meet the four-factor test, explaining that the second, third and fourth factors favored overriding the presumption that the term loan is a security. The court found decisive that the distribution plan for the term loan was relatively narrow and consisted of a relatively small number of sophisticated entities; that the credit agreement repeatedly used terminology indicating that the notes were loans, not securities; and that participating entities were lenders, not investors, which gave buyers ample notice that the instruments were participations in loans.

Following the District Court's dismissal order, the plaintiff moved for leave to amend his complaint. The District Court denied the plaintiff's motion on September 30, 2021, and the plaintiff appealed his case to the Second Circuit on October 28, 2021. The Second Circuit held oral arguments on March 9, 2023.

On March 16, 2023, following the conclusion of oral arguments, the Second Circuit solicited any views that the SEC may wish to share on the issue of whether a term loan is a security, citing the importance of the issue, the parties' diverging positions and policy implications resulting from the court's resolution of the case. The SEC's July 18th letter acknowledged that the Second Circuit has not considered whether this type of syndicated term loan is a security and indicated that it had made diligent efforts to respond to the court's order but ultimately was "not in a position to file a brief" on the issue.

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Simpson Thacher will continue to monitor further developments in this case and any evolution in this important area of the law.

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